Signs of Inflation?

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Introduction

As a trend-following manager, we watch and follow where the market moves. The markets sure have moved since last year, particularly after the COVID-19 crisis. In the wake of changing markets, a few interesting themes stick out: (1) the potential demise of the long bond trend, (2) a stimulus-induced reflation in asset prices, and (3) the shift in market focus from monetary to fiscal policy. All of these market themes lead to concerns over inflation.

Potential for Rising Yields and a Powerful Reflation Trade

Many things changed in 2020, including the markets. Our recent paper[1] examines how trend signals in bonds have turned negative, which may be a first sign that there could be rate hikes and steeper yield curves in the future. Negative bond trends could also show that investors are concerned about the value of longer-term cash flows—that is, concerned that inflation might come back.

In the wake of faltering bonds in 2020, a new powerful cross-asset trend emerged: the reflation trade. Reflation is defined as the expansion of an economy's output by either monetary or fiscal policy. In practical terms, this has meant the act of pumping money into the system has generally sent prices roaring upwards. In simple terms, we have seen equity markets come back to surpass pre-COVID-19 levels; commodity prices experience serious momentum; and continued spending put pressure on the U.S. dollar, weakening its relative purchasing power. It is not necessarily the act of reflation that has sounded some alarms, but the speed of reflation that has caused us to consider what this may mean.

Taking a closer look at reflation, we consider a simple reflation factor: long equities, long commodities, and short the U.S. dollar. Figure 1 plots the return of the reflation factor both with and without equity market returns. We note that without equity returns the reflation factor is even more pronounced across different time periods. In the post-COVID-19 crisis recovery, the factor has been particularly strong.

[1] Kaminski and Kelkar (2021).

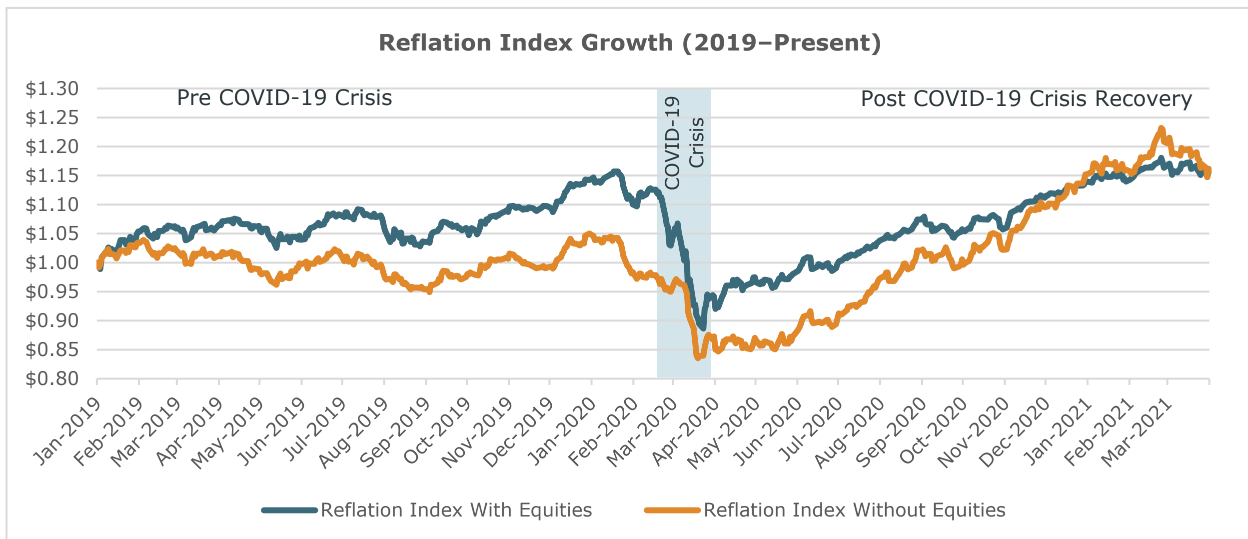

Figure 1: This chart shows two versions of a "Reflation Index," a sample index that can be used to demonstrate the growth of $1 invested in a selection of assets that are likely to be affected by reflation. Reflation Index With Equities is equally weighted between long S&P 500, short U.S. dollar, and long commodities. Reflation Index Without Equities is equally weighted between short U.S. dollar and long commodities. The commodities positions are an equally weighted basket of industrial metals and agricultural commodities. Both indices are risk targeted to 10%. Data is from January 2019 to March 2021. Past performance is not necessarily indicative of future results. Source: AlphaSimplex, Bloomberg.

A Shift From Monetary To Fiscal Policy

Post-2008, markets have turned to the Fed and other central banks to ease their pain with quantitative easing. Rates simply continued their march down to zero or below. In this environment, the negative correlation between bonds and stocks has been a portfolio diversifier. When equities were down, bonds were there to cushion the fall. After the COVID-19 crisis, markets have begun to sing a different tune. From a trend perspective, this means that bonds seem to exhibit less negative correlation to equities and seem to cushion the downside in equities less than in previous years. To demonstrate this, Figure 2 plots the downside capture ratio for classic defensive assets: bonds (the U.S. 10-Year Note), gold, and safe-haven currencies (the Japanese yen and Swiss franc). This graph shows downside capture for three distinct periods: pre-COVID-19, the COVID-19 crisis, and post-COVID-19, with the periods defined by the peak-to-trough drawdown for the S&P 500 during the COVID-19 crisis. Downside capture gives a measure of how much cushion you may have from an asset when the equity market is down.[2] The lack of downside capture suggests the market is focused on fiscal spending, not turning to the Fed on market down days.

[2] We calculate the Down Side Ratio **(DSR)** capture as a ratio of mean bond returns on the n-worst stock return days compared to the mean stock return on those days. Keeping things simple, we do it for the worst ten days for pre-COVID-19 period (January 1, 2019 – February 19, 2020), the COVID-19 crisis period (February 20, 2020 – March 23, 2020), and post-COVID-19 period (March 24, 2020 – March 31, 2021). Note that ten worst days for stocks are typically expected to be negative by design. However, the bond returns on those days can be either positive or negative. For a simple definition see also: https://www.investopedia.com/terms/d/down-market-capture-ratio.asp.

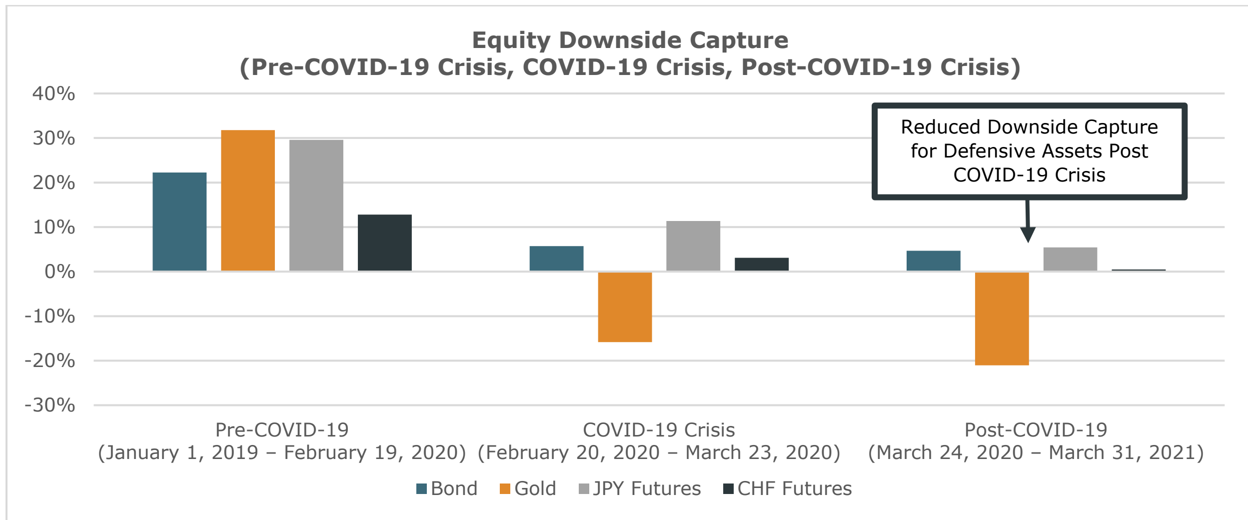

Figure 2: Downside capture for defensive assets: U.S. 10-Year Bonds, gold, and safe haven currencies (the Japanese yen and Swiss franc) during three periods: pre-COVID-19, the COVID-19 crisis, and the post-COVID-19 crisis period. Past performance is not necessarily indicative of future results. Source: Bloomberg, AlphaSimplex.

Concerns over Inflation

Given the recent trend in bonds, massive reflation trades, and the shift from monetary to fiscal policy, inflation may well be a concern for investors. The data is starting to confirm it. To demonstrate this, Figure 3 plots inflation estimates using changes in the CPI[3] and a real-time daily estimate from State Street.[4] The real-time estimates for inflation are moving into moderate territory, with estimates ranging from 1.6% (based on CPI) to 3.4% (based on State Street's PriceStats).

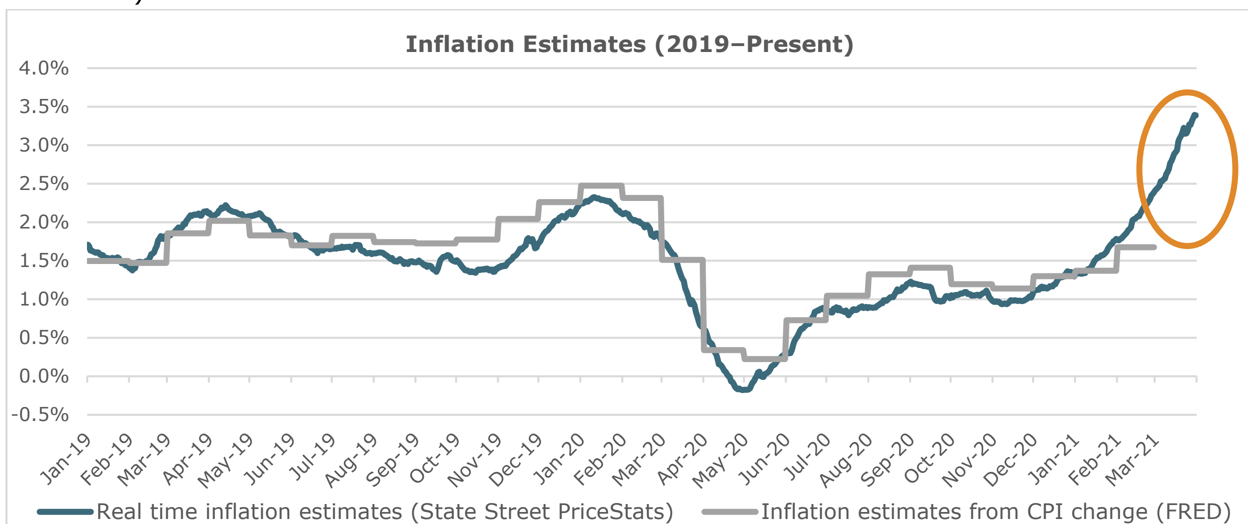

Figure 3: Inflation estimates for January 2019 to March 2021. Past performance is not necessarily indicative of future results. Source: Bloomberg, FRED, State Street PriceStats.

[3] The Consumer Price Index (CPI) is a measure that examines the weighted average of prices of a basket of consumer goods and services, such as transportation, food, and medical care. It is calculated by taking price changes for each item in the predetermined basket of goods and averaging them. Changes in the CPI are used to assess price changes associated with the cost of living. The CPI is one of the most frequently used statistics for identifying periods of inflation or deflation.
[4] State Street PriceStats provides high-frequency measures of inflation and exchange rates drawn from prices on millions of prices sold from online retail.

If inflation were to come back, even at moderate levels, what would this entail? Certainly inflation would affect cash flows and real assets such as bonds and commodities. To consider the impact of inflation, Figure 4 plots the average return for bonds and commodities over different inflationary regimes using the U.S. 10-Year bond and the S&P GSCI® Index[5] as proxies for investments in bonds and commodities. In Figure 4, it is clear that commodities seem to provide larger returns during higher-inflation periods, whereas bonds struggle more with higher inflation. This is because bonds face two opposing forces: the positive impact of a weaker dollar versus the headwinds of rising rates. Either way, consistent with Greyserman and Kaminski (2014), higher inflation tends to mean more trends, which can provide opportunities for trend-following strategies.

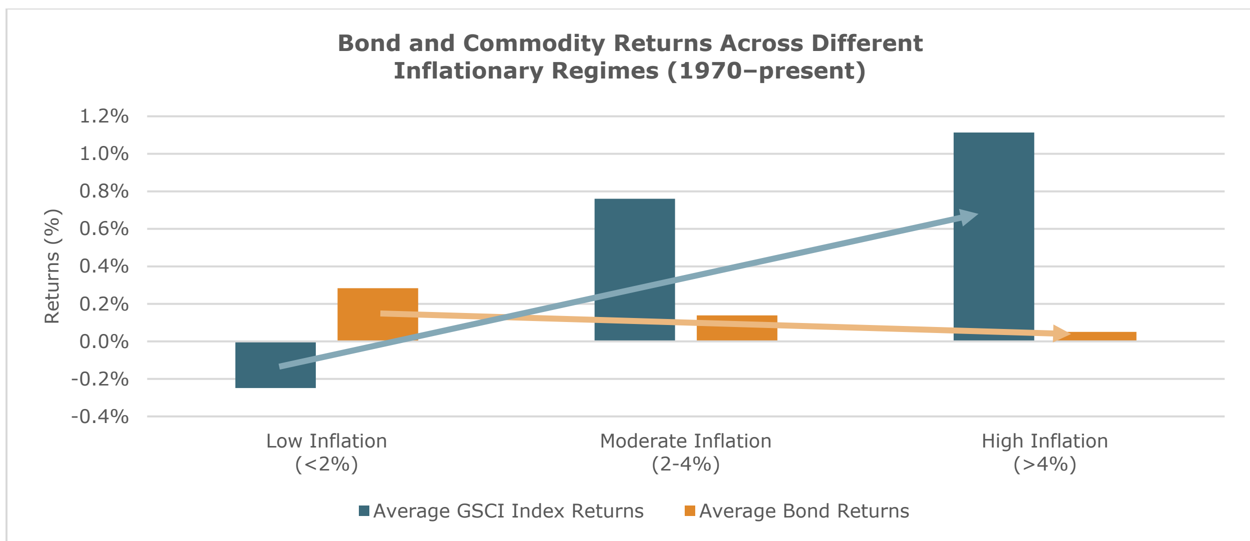

Figure 4: Average bond and commodity returns using the S&P GSCI® Index as a proxy for commodity returns and a price series from the U.S. 10-Year Bond for estimated bond returns. Data from January 1970 to March 2021. Past performance is not necessarily indicative of future results. Source: FRED, Bloomberg, AlphaSimplex.

New market trends (including a new regime for fixed income, reflation trades, and the move from monetary to fiscal policy) and the potential for inflation could create challenges for traditional investment portfolios. But to the trend-follower, this shift can signal opportunity instead of challenge, and we are ready.

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[5] The S&P GSCI® Index is a composite index of commodity sector returns representing an unleveraged, long-only investment in commodity futures that is broadly diversified across the spectrum of commodities. The returns are calculated on a fully collateralized basis with full reinvestment. The combination of these attributes provides investors with a representative and realistic picture of realizable returns attainable in the commodities markets.

References

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